How to Set Up Your Own Hedge Fund

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Traders and money managers often dream about one day running their own hedge fund, managing large sums of money, and competing head to head with the world's top traders. For many, though, this dream remains unfulfilled, because they do not know where to begin and do not want to squander their resources "reinventing the wheel."

The first step toward setting up a hedge fund is getting a better grasp of what exactly a hedge fund is. Hedge funds often are compared to registered investment companies, unregistered investment pools, venture capital funds, private equity funds, and commodity pools. Although all of these investment vehicles are similar in that they accept investors' money and generally invest it on a collective basis, they also have characteristics that distinguish them from hedge funds and they generally are not categorized as hedge funds.

Unlike a mutual fund, a hedge fund is not registered as an investment company under the Investment Company Act and interest in the fund is not sold in a registered public offering. Hedge funds can trade in a wider range of assets than a mutual fund. Portfolios of hedge funds may include fixed income securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments.

As the name indicates, hedge funds initially specialized in hedging and arbitrage strategies. When Alfred Winslow Jones established the first hedge fund as a private partnership in 1949, that fund invested in equities and used leverage and short selling to "hedge" the portfolio's exposure to movements of the corporate equity markets. Although hedge funds today often employ far more elaborate hedging strategies, it is also true that some hedge funds simply use traditional, long-only equity strategies.

Hedge funds are also well known for their fee structure, which compensates the adviser based upon a percentage of the fund's capital gains and capital appreciation. Advisors at hedge funds often invest significant amounts of their own money into the funds that they manage.

Although they still represent a relatively small portion of the U.S. financial markets, hedge funds are a rapidly growing investment vehicle. The growth is fueled primarily by the increased interest of institutional investors such as pension plans, endowments, and foundations seeking to diversify their portfolios with investments in vehicles that feature absolute return strategies – flexible investment strategies that hedge fund advisers use to pursue positive returns in both declining and rising securities markets, while generally attempting to protect investment principal. In addition, funds of hedge funds, which invest substantially all of their assets in other hedge funds, have also fueled this growth. This growth has not escaped the notice of the SEC, which has expressed concerns about the potential impact of hedge funds on the securities markets.

Legal Documents to Set Up a Hedge Fund

To start a hedge fund, documents are prepared to establish the fund and the management company as legal entities. The subscription agreement and the operating agreements for the fund and the management company also must be drawn up. One document that is of particular importance is the private placement memorandum (PPM), since potential investors generally rely heavily on the information that the PPM provides.

The PPM is an extensive document individually created for each hedge fund. Although there are no specific disclosure requirements for the PPM (provided the offering is made solely to accredited investors), basic information about the hedge fund's adviser and the hedge fund itself typically, in fact is disclosed. The information provided is general in nature, varying from adviser to adviser, and it normally discusses in broad terms the fund's investment strategies and practices. For example, disclosures generally include the fact that the hedge fund's adviser may invest fund assets in illiquid, difficult-to-value securities, and that the adviser reserves the discretion to value such securities as it believes appropriate under the circumstances. Also often included is a disclosure about the adviser having discretion to invest fund assets outside the stated strategies.

The PPM usually provides information about the qualifications and procedures for a prospective investor to become a limited partner. It also provides information on fund operations, such as fund expenses, allocations of gains and losses, and tax aspects of investing in the fund. Disclosure of lock-up periods, redemption rights and procedures, fund service providers, potential conflicts of interests to investors, conflicts of interest due to fund valuation procedures, "side-by-side management" of multiple accounts, and allocation of certain investment opportunities among clients may be discussed briefly or in greater detail, depending on the fund. The PPM also may include disclosures concerning soft dollar arrangements, redirection of business to brokerages that introduce investors to the fund, and further disclosure of how soft dollars are used. Copies of financial statements may be provided with the PPM.

The PPM reflects market practice and the expectations of sophisticated investors who typically invest in hedge funds. It also reflects the realization of the sponsors and their attorneys that the exemptions from the registration and prospectus delivery provisions of Section 5 of the Securities Act, available under Section 4(2) of the Securities Act and Rule 506 thereunder, do not extend to the antifraud provisions of the federal securities laws. The disclosures furnished to investors therefore serve as protection to the principals against liability under the antifraud provisions.

"Accredited Investors" and Due Diligence

Offerings made to "accredited investors" exclusively are exempt from disclosure requirements under Rule 506. If the offering is made to accredited investors only, issuers are not required to provide any specific information to prospective investors. The term "accredited investors" is defined to include:

- Individuals who have a net worth, or joint net worth with their spouse, above $1,000,000, or who have income above $200,000 in the last two years (or joint income with their spouse above $300,000) and a reasonable expectation of reaching the same income level in the year of investment, or who are directors, officers, or general partners of the hedge fund or its general partner; and

- Certain institutional investors, including banks, savings and loan associations, registered brokers, dealers and investment companies, licensed small business investment companies, corporations, partnerships, limited liability companies, and business trusts with more than $5,000,000 in assets; and

- Many, if not most, employee benefit plans and trusts with more than $5,000,000 in assets.

Of course, the hedge fund may wish to allow non-accredited investors into the fund, in which case it will not be exempt from disclosure requirements. Moreover, even if the fund will only open to "accredited investors," those investors will want information about the fund before buying into it. Indeed, prospective investors will often subject the fund and its managers to an extensive process of due diligence. Investors often spend significant resources, frequently hiring a consultant or a private investigation firm, to discover or verify information about the background and reputation of a hedge fund adviser. Prospective investors may gain access to brokers, administrators, and other service providers during the initial due diligence process, verifying most information contained in the PPM (including the adviser's history). Since the PPM usually is the starting point for those conducting due diligence, it remains a crucial document, even for offerings exclusively for "accredited investors."

"Do I need to register?"

In some cases, subject to a state-by-state determination, a fund manager may be required to sign up with his state as an investment adviser if he has less than $25 million under management. For amounts under management between $25 million and under $30 million, the fund manager may choose the regulator – either the state or the SEC. If the fund manager has more than $30 million under management, he would need to register with the SEC as an investment adviser.

When the situation is complicated with investors from multiple states, usually a notice filing is required. It is impossible to make a blanket statement pertaining to

registration requirements and exemption options, except to say that they vary by state and fund structure.

A commodities pool operator (CPO) falls under another set of registration requirements. He must take the Series 3 exam, although it is not required that he be sponsored to do so. Additionally, the CPO and his related fund may end up under regulation from the Commodity Futures Trading Commission (CFTC) and its self-regulatory organization, the National Futures Association (NFA).

The Series 7 has no value to either a Registered Investment Adviser (RIA) or CPO. If someone has a current Series 7 (they have been registered within the past two years with a broker/dealer), he can choose to take the Series 66 instead of the Series 65. The Series 7 plus the Series 66 is always (in all states) equivalent to the Series 65. After two years of not being with a broker/dealer, all prior registrations (such as a Series 7) expire and are no longer valid. Similarly, if someone previously passed the Series 65, but did not register it with either a broker/dealer or an investment advisory firm, the exam has expired and will need to be taken again.

Alternatives to Full Hedge Fund Development

Given the registration requirements and the extent of disclosure necessary, it is no wonder that many fledgling hedge fund managers abandon their business plan due to potentially onerous startup requirements. There is, however, an alternative for hedge fund startups that do not have yet the track record necessary to attract new investors.

An "Incubator" can be created by breaking down the hedge fund development process into two stages and isolating the first. The first stage sets up the fund and management company entities, as well as pertinent operating agreements and resolutions. This is enough to allow the hedge fund to begin trading, usually with the manager's own funds. By trading under this structure, the manager can develop a track record, which can be marketed legally to potential investors in the offering documents. Then, in the second stage, the PPM is developed with the performance information included. The Incubator method affords the opportunity for those with a skill for trading (often in their personal accounts) to break down the hedge fund development process into a manageable undertaking.

One of the caveats of the Incubator option is that the fund manager cannot be compensated for his trading activity. Thus, the acceptance of outside funds, although permitted, exposes the fund manager to fiduciary obligations for which he cannot receive any compensation. If outside funds are to be accepted, careful planning is required to avoid potential legal issues.

Offshore

Though often assumed, offshore funds are not established for the purpose of avoiding U.S. taxation. This is the wrong reason to consider an offshore fund. In short, setting up an offshore fund is not a tax minimization strategy, as U.S. citizens and resident aliens (e.g., green card holders) are taxable on their worldwide income. The U.S. tax results depend on the nationality and domicile of the fund manager and his or her management company.

The word "offshore" has a certain mystique to many. Offshore hedge funds are investment vehicles organized in offshore financial centers ("OFC"). OFCs are countries that cater to the establishment and administration of mutual and hedge funds ("funds"). Offshore funds offer securities primarily to non-U.S. investors and to U.S. tax-exempt investors (e.g. retirement plans, pension plans, universities, hospitals, etc.). U.S. money managers who have significant potential investors outside the United States and tax-exempt investors typically create offshore funds. In many OFCs, the low costs of setting up a company, along with a kind tax environment, makes them attractive to establishing funds. Offshore funds generally attract the investment of U.S. tax-exempt entities, such as pension funds, charitable trusts, foundations, and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favor investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds. Offshore hedge funds may be organized by foreign financial institutions or by U.S. financial institutions or their affiliates. Sales of interests in the United States in offshore hedge funds are subject to the registration and antifraud provisions of the federal securities laws.

Offshore hedge funds typically contract with an investment adviser, which may employ a U.S. entity to serve as sub-adviser. An offshore hedge fund often has an independent fund administrator, also located offshore, that may assist the hedge fund's adviser to value securities and calculate the fund's net asset value, maintain fund records, process investor transactions, handle fund accounting, and perform other services. An offshore hedge fund sponsor typically appoints a board of directors to provide oversight activities for the fund. These funds, especially those formed more recently, may have directors who are independent of the investment adviser.

Consider setting up an offshore fund if you manage money for foreign and/or U.S. tax-exempt individuals and businesses. Under U.S. income tax laws, a tax-exempt organization (such as an ERISA plan, a foundation, or an endowment) engaging in an investment strategy that involves borrowing money is liable for a tax on "unrelated business taxable income" ("UBTI"), notwithstanding its tax-exempt status. The UBTI tax can be avoided by the tax-exempt entity by investing in non-U.S. corporate structures (i.e., offshore hedge funds).

A manager planning a new fund needs to answer a few key questions in order to decide where to register, what kind of investor the vehicle is for, where those investors are, and what they want in a domicile. Experienced alternatives investors typically are less worried about domicile than are first-time investors. Funds designed for mass distribution to the retail market need to have more regulation than those meant for

wealthy individuals who already are in hedge funds. Some institutions may be bound by rules that limit investment to regulated jurisdictions, while others face no such requirement.

Single-strategy managers continue to gravitate to traditional Caribbean locations and Bermuda, where costs are lower and the regulatory burden lighter than in Dublin and Luxembourg. Basic administrative fees are similar in all jurisdictions, but regulatory oversight adds to the expense in the European centers. For instance, in Dublin, funds need to have a custodian, which is not the case in the Cayman Islands. While banks and large fund companies like to have regulations for their retail vehicles to reassure investors, the majority of hedge fund managers are small operators, for whom the extra costs can be a major burden.

Hedge funds tend to be domiciled in a handful of places worldwide. In the United States, domestic hedge fund businesses tend to cluster in a few states, in particular California, Delaware, Connecticut, Illinois, New Jersey, New York, and Texas. Each state has different tax and regulatory laws. Outside the United States, several centers in the Caribbean and Europe present different benefits and costs to fund managers. Regulatory burdens and expenses can be worth bearing, depending on the nature of the investment vehicle and its clients. A key distinction is sometimes forgotten. The domicile of the fund need not be the same as that of its administrator and custodian. A fund's service providers can hail from the other side of the world. Moreover, the service providers' jurisdiction sometimes turns out to be the more important issue. Let us specifically review several of the top offshore funds havens around the globe. A potential fund manager would first want to avoid any country lacking monetary or political stability.

Bermuda: Any fund that wants to incorporate in Bermuda has to be approved by the Bermuda Monetary Authority. The investment manager, as well as the administrator, prime broker, custodian, and auditors, are subject to BMA approval. Any change of service providers requires the prior consent of the BMA. The authority conducts due diligence on proposed service providers and investment manager personnel, including for instance, background checks in databases to find out whether there has been any legal action or NASD or SEC disciplinary sanctions against such individuals. In addition, a Bermuda incorporated fund is required to file monthly reports with the BMA, providing financial information such as the fund's net asset value, change in NAV from the prior month, amounts of monthly subscriptions, and redemptions and number of securities outstanding. The administrator usually makes these filing. Incorporation can take longer in Bermuda because of BMA approval rules; however, the process includes preparation of offering documents and service provider agreements, which as a practical matter have to be ready before the fund can commence operation in any case. For comparison, in the Cayman Islands, fund incorporation can occur earlier in the process, but afterwards time has to be spent preparing documentation.

British Virgin Islands: More than 2,000 mutual funds worth an estimated $55 billion currently are incorporated in the BVI. So too are many hedge funds. In all, 11 banks

operate on the BVI, catering mainly to high net-worth wealth and trust management. The government launched new laws to placate the international community's concerns over a lack of financial regulation.

Cayman Islands: The Cayman Islands is one of the world's lowest tax domiciles with no personal or corporate taxes. Registering in the Cayman Islands does not involve much due diligence by the Cayman Islands Monetary Authority during the incorporation process, but is not necessarily cheaper or faster overall. Cayman does not require monthly reports or prior consent to change service providers, but before a fund can commence trading, it has to be registered with CIMA under the Mutual Funds Law (subject to some exceptions). This means identifying all service providers to the fund and providing certain information about the fund and the offering of its securities, and CIMA has to be notified of any subsequent changes. However, currently the Cayman Islands does not require a fund to file regular reports with CIMA.

The Bahamas: The Bahamas is a very low tax jurisdiction. Banking, wealth and asset management are core industries, with around $200 billion under management. The island also boasts some 700 mutual funds with around $100 billion.

Master-Feeder Funds

The corporate structure of a hedge fund depends primarily on whether the fund is organized under U.S. law ("domestic hedge fund") or under foreign law and located outside of the United States ("offshore hedge fund"). The investment adviser of a domestic hedge fund often operates a related offshore hedge fund, either as a separate hedge fund or often by employing a "master-feeder" structure that allows for the unified management of multiple pools of assets for investors in different taxable categories.

The master/feeder fund structure allows the investment manager to manage money collectively for varying types of investors in different investment vehicles without having to allocate trades and while producing similar performance returns for the same strategies. Feeder funds invest fund assets in a master fund that has the same investment strategy as the feeder fund. The master fund, structured as a partnership, engages in all trading activity. In today's trading environment, a master/feeder structure will include a U.S. limited partnership or limited liability company for U.S. investors and a foreign corporation for foreign investors and U.S. tax-exempt organizations. The typical investors in an offshore hedge fund structured as a corporation will be foreign investors, U.S.-tax exempt entities, and offshore funds of funds.

Although certain organizations, such as qualified retirement plans, generally are exempt from federal income tax, unrelated business taxable income (UBTI) passed through partnerships to tax-exempt partners is subject to that tax. UBTI is income from regularly carrying on a trade or business that is not substantially related to the organization's exempt purpose. UBTI excludes various types of income such as dividends, interest, royalties, rents from real property (and incidental rent from personal property), and gains from the disposition of capital assets, unless the income is from

"debt-financed property." Debt-financed property is any property that is held to produce income with respect to which there is acquisition indebtedness (such as margin debt). As a fund's income attributable to debt-financed property allocable to tax-exempt partners may constitute UBTI to them, tax-exempt investors generally refrain from investing in offshore hedge funds classified as partnerships that expect to engage in leveraged trading strategies. As a result, fund sponsors organize separate offshore hedge funds for tax-exempt investors and have such corporate funds participate in the master-feeder fund structure.

If U.S. individual investors participate in an offshore hedge fund structured as a corporation, they may be exposed to onerous tax rules applicable to controlled foreign corporations, foreign personal holding companies, or a passive foreign investment company (PFIC). To attract U.S. individual investors, fund sponsors organize separate hedge funds that elect to be treated as partnerships for U.S. tax purposes so that these investors receive favorable tax treatment. These funds participate in the master/feeder structure. Under the U.S. entity classification rules, an offshore hedge fund can elect to be treated as a partnership for U.S. tax purposes by filing Form 8832, "Entity Classification Election," so long as the fund is not one of several enumerated entities required to be treated as corporations.

Legal Development Process

The legal development process is one that requires careful planning. As seen above, a variety of regulatory issues intersects concurrently when developing a fund: tax, registration, entity type and classification, jurisdiction, security type, and so on. The wisest course of action for those thinking about developing a fund is to consult with qualified legal counsel before taking definitive steps. Due to the many regulatory issues that must be complied with, it is best to define the structure of your fund properly before commencing any form of fund development or engaging the services of administrators or service providers.

The legal development process normally begins with a planning consultation with an attorney experienced in forming hedge funds. This is where important determinations such as registration, jurisdiction choice, and utilization of safe harbors are made. The consultation may expose areas (outside the legal process) that need further planning, thus requiring the manager to deal with those issues before proceeding. After clearing up any such issues, a full engagement is entered into and the legal development process begins. The fund and management company entities are first formed in their appropriate jurisdictions. This enables the fund manager to begin the process of opening bank and brokerage accounts and setting up the administrative functions of the fund. After the entities are formed, the legal team gathers the necessary information to form the operating agreements for the entities and then the offering documents, first in draft stage and then finalized for distribution to prospective investors. The legal process of setting up a hedge fund usually can be completed within 60-90 days, though registration as a Commodity Pool Operator, specialized circumstances, or delays in providing information can lengthen the process.

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